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No. 79-509

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1979

EXXON CORPORATION,
Appellant,
vs.
WISCONSIN DEPARTMENT OF REVENUE,
Appellee.

On Appeal From the Supreme Court Of Wisconsin

BRIEF OF THE STATES OF ILLINOIS, CONNECTICUT, MASSACHUSETTS, MINNESOTA, AND VERMONT AS AMICI CURIAE

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INTEREST OF THE AMICI CURIAE

Every State which imposes an income tax on corporations relies upon an apportionment formula to determine the portion of multistate corporate income which it will tax.[1] Exxon seeks to avoid the effects of the apportionment formula, as applied in Wisconsin, by offering a method of accounting for income which it has developed for its own internal management and financial purposes. If Exxon is permitted to be taxed on its alternate method of accounting, the concept of state taxation based upon formulary apportionment will be rendered devoid of meaning and effect. Corporate taxpayers will be invited to devise methods of accounting which, though based upon generally accepted principles of accounting, do not accurately reflect income for State tax purposes. State revenues will be adversely affected, the cost and complexity of auditing tax returns will be dramatically increased, and the degree of fairness and uniformity the States have achieved in the taxation of residents and corporations will be undermined.

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[1] Prentice Hall, All-States Tax Reporter, para. 223; *Moorman, infra,* (Powell dissenting) 437 at 283.

This brief is submitted on behalf of the States of Connecticut, Illinois, Massachusetts, Minnesota, and Vermont. It is filed pursuant to Rule 42(4) of the Rules of this Court, and the consent of the parties is not required.

A STATE TAX WHICH FAIRLY APPORTIONS THE INCOME OF A VERTICALLY INTEGRATED BUSINESS DOES NOT VIOLATE THE DUE PROCESS CLAUSE SIMPLY BECAUSE THE BUSINESS HAS DEVELOPED A DIFFERENT METHOD OF ACCOUNTING FOR ITS INCOME

A. INTRODUCTION

Exxon claims that the method of "separate functional accounting" employed by Humble Oil and Refining Company (Humble) accurately reflects the income earned by each of the operational functions within Humble and that a State will violate the Due Process Clause if it imposes an income tax in a manner which overlooks these separate functional operations. Exxon finds support for this claim in two arguments. First, it reads *Moorman Manufacturing Co.* v. *Bair,* 437 U.S. 267 (1978) as an acknowledgment "that separate functional accounting may be used by a taxpayer to identify the income from various phases or functions of a taxpayer's operations, and thereby establish that the income attributable to a given state is 'out of all appropriate proportion to the business transacted . . . in that state.' *Hans Rees' Sons* v. *North Carolina,* 283 U.S. 123, 135 (1931)." Appellant's Brief p. 13-14. Exxon then argues that the testimonial and documentary evidence it presented before the Wisconsin Tax Appeals Commission established the integrity of the posted price and transfer price system used to determine income by function and that this was the type of proof missing in *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission,* 266 U.S. 271 (1924), *Butler Brothers* v. *McColgan,* 315 U.S. 501 (1942) and *Moorman, supra,* but which was present in *Hans Rees', supra.* Exxon's second

argument is essentially a disagreement with the Wisconsin Supreme Court's interpretation of what constitutes apportionable income under Wis. Stat. sec. 71.07(1) + (2) and the assertion that the Court's interpretation results in the taxation of extraterritorial activities which bear no rational relationship to the activities conducted within Wisconsin.

None of these arguments should be addressed until a most basic question is answered—what is wrong with the result reached by Wisconsin's apportionment formula? During the years in question Humble's service stations and retail outlets sold gasoline, oil, lubricants and automobile accessories. Annual sales in Wisconsin ranged from $12,980,144. in 1965 to $16,384,760. in 1968. (A.617) Humble's tangible property in Wisconsin increased from $11,233,948 in 1965 to $14,539,290. in 1968. (A.611) Humble filed tax returns claiming it did not owe any state tax for any of the years.[2] Wisconsin, after determining apportionable income and the apportionment factors, assessed Humble's tax liability as $316,471. for the four years in question. Is this result "out of all appropriate proportion to the business transacted . . . in that state," *Hans Rees', supra,* at 135, or has it "led to a grossly distorted result," *Norfolk & Western R. Co.* v. *State Tax Commission,* 390 U.S. 317, 326 (1968)?

B. RELIANCE UPON A FORMULA FOR APPORTIONING INCOME IS A FUNDAMENTAL PRINCIPLE OF STATE INCOME TAXATION.

This Court has long recognized the importance and the validity of the principle of apportionment in the imposition of state taxes. *Adams Express Co.* v. *Ohio,* 165 U.S. 194 (1896),

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[2] In its 1965-68 returns, Humble sought to avoid the apportionment of any income by accounting for profit (or loss) according to what it considered to be Wisconsin sources. Exxon now concedes, without any explanation, that the income it attributes to its nationwide marketing operations should be subject to formulary apportionment. (Appellant's Brief p. 33)

rehearing 166 U.S. 185 (1897) (an *ad valorem* property tax); *Underwood Typewriter Co.* v. *Chamberlain,* 245 U.S. 111 (1920); *Bass, Ratcliff & Gretton* v. *State Tax Commission, supra;* and *Moorman Manufacturing Co.* v. *Bair, supra* (net income tax cases); and *Flint* v. *Stone Tracy Co.,* 220 U.S. 107 (1911); *Ford Motor Co.* v. *Beauchamp,* 308 U.S. 313 (1939) (net worth or franchise tax cases). Every one of the 45 states which impose a corporate income tax rely on some type of apportionment formula to determine the amount of taxable income earned by a multistate business.[3] By far the most common formula is the 3-factor formula which compares instate to total property, payroll and sales.[4] (Wisconsin uses the cost of manufacturing instead of a payroll factor.) An apportionment formula is a method of approximation; it is not a method of item by item determination according to geographical source, type of transaction, type of income, or phase of business operation. It is a reasonable approximation because it is based upon the premise that instate income compared to total corporate income is directly proportional to instate and total property, payroll and/or sales. These factors take into account a proper spectrum of the corporate presence within and without the State. The formula is also a recognition that attempts to identify the exact source of income, whether by geography, function or whatever, ultimately lead to unrealistic assumptions, arbitrary decisions, unverifiable results, and time-consuming and expensive accounting and audit programs. A critical feature of the apportionment formula is "apportionable income"—the amount by which the average of the various factors is multiplied in order to arrive at taxable income. Although Wisconsin excluded from apportionable income Humble's income from crude oil sold to third parties and income from intangible assets (dividends, interest, capital gains, rents, etc.), most state statutes would apportion all net income from

[3] See note 1.

[4] See note 1.

Humble's petroleum business regardless of its nature or geographical source. A state which fairly apportions income is not required to yield to a state which allocates a portion of that income. *Johns-Manville Products Corp.* v. *Comm. of Rev. Adm.* 115 N.H. 428 (1975), appeal dismissed, 423 U.S. 1069 (1976).

Formulary apportionment and separate accounting (by whatever source) are fundamentally different methods of determining income for state tax purposes. The States have adopted formulary apportionment, and this Court has approved that exercise of taxing authority absent Congressional legislation. *Moorman, supra.* There must be compelling reasons to abandon full, fair apportionment. Neither increased revenues to States nor savings to taxpayers could justify the complexities, distortions and costs created by employing item-by-item allocations. Thus, several States have held that there must first be an explicit finding that full, fair apportionment does not fairly represent the extent of the taxpayers instate business activities. *St. Johnsburry Trucking Co.* v. *New Hampshire,* CCH NH State Tax Rptr, Par. 200-121 (1978); *Amoco* v. *Arnold,* 213 Kas. 636, 518 p. 2d 453 (1974); *Donald M. Drake Co.* v. *Dept. of Revenue,* 263 Ore 26, 500 P2d 1041 (1972); *Kennecot Copper Corp.* v. *State Tax Comm.,* 27 Utah 2d 119, 493 P2d 632 (1972); *Superior Oil Co.* v. *Franchise Tax Board,* 34 Cal Reptr 545, 386 P2d 33 (1963). Otherwise the State revenues will be jeopardized and the fairness of the tax system to all other taxpayers will be called into question; Exxon simply has not shown that the result reached by Wisconsin's apportionment formula is out of proportion to the business conducted in the state.

Appellant's brief (pp. 40-43) refers to State court decisions upholding direct allocation and separate accounting. Either for statutory or factual differences, or both, those cases are distinguishable, and they do not have a bearing on how Wisconsin should interpret its statute. For example, the Kansas statute involved in *Webb Resources Inc.* v. *McCoy,* 401 P.2d 879, at 885 (Kan., 1965) expressly preferred direct allocation rather

than formulary apportionment. Thus, the formula method could be used only if direct allocation was impracticable or the books did not clearly reflect income. Moreover, the statute was repealed in 1963. *Standard Oil Co. of Indiana* v. *Wisconsin,* 223 N.W. 85, at 86 (192), involved statutory provisions similary to those in this case except that the controlling phrases "not requiring apportionment under sub(2)" and "when the business of such person is not an integral part of a unitary business" did not appear in the statute at that time. None of the State cases relied upon by Exxon support its argument that the Wisconsin Supreme Court reached an unconstitutional result in the interpretation of Wisc. Stat. 71.07 (1) & (2).

C. SEPARATE FUNCTIONAL ACCOUNTING MAY BE USEFUL TO HUMBLE'S MANAGEMENT BUT IT IS UNACCEPTABLE FOR STATE TAX PURPOSES.

The evidence presented to the Tax Appeals Commission indicated that there was a corporate purpose to be served by Humble's separate functional accounting. It allowed corporate management and coordination and services management to guage the profitability of the various operations and thereby be in a better position to make decisions concerning the efficiency and investment potential of each operation. Exxon argued that if it could establish that its use of posted field prices and transfer prices conformed with generally accepted accounting principles, then it should be taxed *as if* it operated the three departments as separate businesses. Exxon's accounting by operations is a type of financial accounting as opposed to tax accounting. Two of Exxon's witnesses, Mr. Wehner and Mr. Solomon, recognized the validity of this distinction. (A. 455 and 510-11).

This Court has recently observed that financial accounting serves vastly different objectives than tax accounting, and that the former, even though it may reflect generally accepted accounting principles, does not necessarily reflect income for tax

purposes. *Thor Power Tool Co.* v. *Commissioner,* ____, U.S. ____, 99 S. Ct. 773 (1979).

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. 99 S. Ct. 786.

This was one of the reasons the Court held that Thor Power's writedown of "excess" inventory was not an allowable deduction for federal purposes even though it may have been in conformity with generally accepted accounting principles.

This Court went on to state:

> Finally, a presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration. Accountants long have recognized that "generally accepted accounting principles" are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. "Generally accepted accounting principles," rather, tolerate a range of "reasonable" treatments, leaving the choice among alternatives to management. Such, indeed, is precisely the case here. Variances of this sort may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax. *If management's election among "acceptable" options were dispositive for tax purposes, a firm, indeed, could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay.* Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable. 99 S. Ct. 787. (emphasis added) (footnotes omitted)

Mr. Jeager, a manager of the Supply Department, testified that he managed the crude oil supplies of the company, including the purchase, sale, exchange or transfer to refineries

of the company's crude, and that he was involved in the development of pricing strategies. (A. 296-7) For some reason, the Supply Department is not treated as a profit center as are marketing, refining or exploration and production. This is precisely the type of "unilateral decision" which makes Humble's separate functional accounting unacceptable for state tax purposes.

Thor Power recognized that use of financial accounting for tax purposes could lead to inequitable and unenforceable tax administration. This Court has also stated that financial accounting should not be used to impeach the results of formulary apportionment:

> Accounting practices for income statements may vary considerably according to the problem at hand. (citation omitted) A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders. (citation omitted) That may be due to the fact (citation omitted) that a State in attempting to place upon a business extending into several States 'its fair share of the burden of taxation' is 'faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders.' Furthermore, the particular system used may not reveal the facts basic to the State's determination. (citation omitted) In either aspect of the matter the results of the accounting system employed by appellant do not impeach the validity or propriety of the formula which California has applied here. ***Butler Bros.***, v. ***McColgan,*** 315 U.S. 507-8

The evidence offered by Exxon to impeach Wisconsin's method of apportionment is based solely upon its "separate functional accounting." One cannot imagine a more obvious contradiction to the unanimous decision in ***Butler Bros., supra.***

Humble's merger with Exxon raises additional doubts as to the applicability of its internal methods of accounting for state income tax purposes. At least some public officials have been given the impression that separate functional accounting does

not exist for Exxon, if not for Humble. In a letter dated December 5, 1975 from Senator Philip A. Hart, Chairman of the Antitrust and Monopoly Committee of the Senate Judiciary Committee to the Chief Executive Officer of Exxon Corporation, Sen. Hart requested "profit and loss statements and balance sheets, audited or unaudited, covering separately production, transmission, refineries and marketing." *Hearings on S. 2387 and Related Bills Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary,* 94th Cong., 1st Sess. 1811 Vol II (1975) (hereinafter cited as 1975 Hearings). In a letter dated January 6, 1976 to Senator Hart, a representative of Exxon wrote:

> " . . . Exxon Corporation's financial records are not maintained on a functional or segment basis similar to those categories set forth in your (letter dated December 5, 1975) . . . the petroleum business is unitary in nature. The most meaningful segmentation of our operations is the "upstream"/"downstream" segmentation previously furnished for the years 1972-1974. Further breakdowns require many allocations and assumptions, which could lead to erroneous comparisons of data between various companies and hence erroneous conclusions." 1975 Hearings 1817.

Although these letters relate to Exxon, not Humble, and involve the years 1972-75, instead of 1965-68, some explanation appears to be in order if only to clarify whether or not the petroleum business is unitary in nature and whether allocations and assumptions about different operations would lead to erroneous comparisons.

D. WISCONSIN'S DETERMINATION OF APPORTIONABLE INCOME DOES NOT VIOLATE THE DUE PROCESS CLAUSE

A review of the testimony before the Commission and of the facts as summarized by the Wisconsin Supreme Court and by the parties makes one wonder, if a vertically integrated oil

company is not a unitary business, what is? Every state tax statute which distinguishes between business and nonbusiness income or which makes reference to a unitary business certainly anticipates that such an entity exists. There is no doubt that within Humble there was a flow of product from one operation to another, there was a flow of funds within the organization, and there was a centralized management which, among other things, attempted to maximize corporate profits by coordinating demand and supply imbalances for each phase of operations. Neither the state of South Carolina nor Oregon had difficulty finding that Humble was a unitary business. See *Exxon Corp.* v. *South Carolina Tax Com'n,* ____ S.C. ____, 258 S.E. 2d 93 (1979) and *Humble Oil & Refining Co.* v. *Dept. of Revenue,* 4 OTR 284 (1971). The only real question is whether Wisconsin Statute sec. 71.07(1) & (2) requires the Department of Revenue to apportion all of the income of a unitary business or whether it must exclude all situs income. This is a question of State law, and the Wisconsin Supreme Court is properly the final arbiter. In a similar case of statutory construction, the Supreme Judicial Court of Maine, when asked to decide whether certain income was apportionable under its statute, stated:

> It could not have been the purpose of this legislation to create a system for rationalizing state income taxation of multistate or multinational business concerns, only to render it practically ineffective by requiring a showing that various items of out-of-state income, received in the regular course of business, were connected in some demonstrable way with activities of the taxpayer in Maine. *Albany International Corp.* v. *Halperin,* ____ Me. ____, 388 A.2d 902, 906 (1978)

Exxon's legal analysis and conclusion that Wisconsin's apportionment of all unitary income violates the Due Process Clause does not withstand close scrutiny. Exxon argues that the contribution or dependency test should be rejected.[5]

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[5] The test was originally used to define a unitary business, see Altman & Keesling, *Allocation of Income in State Taxation,* (2d ed.) p. 101.

> It is submitted that mere contribution is not a constitutionally appropriate test, and that the proper test for the rational relationship element of Due Process should involve the question of whether the in-state activity is "necessary" to one or more of the taxpayer's out-of-state functional operations; and if this finding is affirmative, then apportionment may be utilized as to only those functional operations of the taxpayer where this rational relationship exists. (Appellant's Brief p. 29-30).

First, the "rational relationship" requirement of the Due Process Clause, as set forth in *Moorman, supra,* is not a new concept in need of definition. It reflects the constitutional principle that states may not tax extraterritorial values. States do not tax extraterritorial values simply because one or more phases of a company's operations take place outside of the taxing state. *Butler Bros., supra; Bass, Ratcliff, supra; Ford Motor* v. *Beauchamp, supra.* Secondly, Exxon does not offer any authority or reasoning why the contribution or dependency test should be rejected. On its face, a contribution or dependence among business activities signifies a rational relationship. Moreover, the "necessary" test was implicitly rejected in *Butler Bros., supra,* The Court rejected Butler Bros.' argument that the sales in California had no effect on the purchasing power of the company. It reasoned that the same argument could be made in every state, yet there obviously is a cumulative effect of the sales in each state which contributes to the profitability of the purchasing operations. Once it is found that a business' in-state activities contribute to or are dependent upon its out-of-state activities, the nexus requirement of the Due Process Clause has been fulfilled. Finally, Exxon has focused a great deal of attention on the rational relationship between the business activities conducted within and without a State. This is not the relationship which is the subject of the Due Process requirement. "[T]he income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing state'." *Moorman,* 437 U.S. at 273. Any apportionment for-

mula can satisfy this test. (Of course, a three factor formula is more presumptively correct than a single factor in that it is representative of the economic factors of production.) The 'income attributed to the States' is the number generated by the apportionment formula. That formula incorporates 'values connected with the State'—property, payroll (cost of manufacturing) or sales. The income attributed to the state compared to total corporate (or unitary) income *is proportional to* the ratio of instate to total corporate (or unitary) property, payroll and/or sales. This is a rational relationship. *Hans Rees, supra,* has applicability only when the apportionment formula, in that case a single property factor, yields a figure which is out of all appropriate proportion to the business conducted in the State. The instant case is not one in which Exxon has shown that it is being taxed on 83% of its income while only 17% of its income had its source in the taxing state. This is a case where four years of sales in the state represented .41% of total company sales, yet Exxon is being taxed on .22% of total company net income.

CONCLUSION

For the foregoing reason, *Amici* respectfully request this Court to affirm the decision of the Wisconsin Supreme Court.

Respectfully submitted,

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